18.02 Direct Method

Operating Activities

There are two acceptable approaches to preparing the Operating activities section of the statement of cash flows:

- **Direct method** – (direct cash approach – preferred method) Cash sources and uses related to each account in income from continuing operations are listed individually.
  - Sales are adjusted for changes in A/R.
  - COGS are adjusted for changes in both Inventory and A/P.
  - Selling expenses may be adjusted for changes in allowance for credit losses (A/R) and accumulated depreciation if they are included in selling expense.
  - Interest expense is adjusted for amortization of bond discount or premium.
  - Income tax expense is adjusted for changes in current and deferred taxes.

  Note 1: Gains and losses from sale of Investments (other than trading), and expenses not requiring the use of cash (depreciation, amortization) are not reported.

  Note 2: If selling expense includes depreciation or credit loss expense, they should be deducted since they do not involve the payment of cash.

- **Indirect method** – (reconciliation approach) Income from continuing operations is reconciled to net cash flow from operating activities by adjusting for differences related to changes in balance sheet operating accounts (such as accounts receivable, inventory, and accounts payable) and noncash income items (such as depreciation, amortization, and deferred income taxes).
  - Both are acceptable methods, but if the statement is prepared using the direct method, the indirect method MUST be presented as a supplementary schedule.

Roger Company
Income Statement
FYE December 31, 20X3

Sales	$600
COGS	(200)
Selling expense (Includes $20 credit loss expense)	(100)
General & administrative expenses	(40)
Depreciation expense	(50)
Interest expense	(30)
Equity in earnings of Investee	10
Income tax expense	(60)
Gain on sale of Avail-for-sale security (AFS)	10
Net Income	**$140**

Selected Balance Sheet account changes for the year	
Increase in A/R	$80
Increase in Investment under Equity method	10
Increase in Inventory	30
Increase in A/P	20
Increase in Allowance for credit losses (A/R)	20
Increase in Accumulated Depreciation	50
Decrease in Bond Discount	5
Decrease in Deferred tax liability	10
Increase in Taxes Payable	40

Changes in the selected Balance Sheet accounts during the year:

Account	Debit	Credit
A/R	80	
Investment - Equity	10	
Inventory	30	
A/P		20
Allowance A/R		20
Accum. Depreciation		50
Bond Discount		5
Def. tax liability	10	
Taxes Payable		40

Direct Method (Direct Cash Approach)

Take every income statement item and convert from the accrual method of accounting back to Cash.

1. **Cash collected from Customers** (A/R increased by 80)

Cash (Plug)	520	
A/R (Change in A/R)	80	
Sales		600

2. **Payments for Purchases** (Inventory increased by 30 and A/P increased by 20)

COGS	200	
Inventory (change)	30	
A/P (change)		20
Cash (plug)		210

3. **Payments for Selling expenses** (Allowance for credit losses increased by 20; credit losses are considered a selling expense.)

Selling expenses	100	
Allowance for credit losses		20
Cash		80

4. **Payments for G&A expense**

G&A expense	40	
Cash		40

5. **Depreciation expense** – Ignore under the direct method since there was no effect on cash.

Depreciation expense	50	
Accumulated depreciation		50

6. **Interest expense** (amortization of Discounts or Premiums changed by 5. Is covered in more detail in the Bond section).

Interest expense	30	
Amortization of discount		5
Cash		25

7. **Equity in earnings** – when an investment is accounted for under the Equity method, as the Investee earns income, the investor recognizes their share of the income on their Income Statement, even though they have not yet received cash.

Investment under the equity method	10	
Equity in earnings of Investee		10

8. **Income tax expense** (Deferred tax liability decreased by 10, taxes payable increased by 40)

Income tax expense	60	
Deferred tax liability	10	
Income taxes payable		40
Cash		30

9. **Gain on sale of investment** – Assume an Available-for-sale (AFS) investment that had an original cost of $50, was sold for $60. The cash proceeds would be considered an Investing activity, so the gain is a nonoperating gain and should not be part of Operating activities.

Cash	60	
Investment		50 (cost)
Gain on sale of AFS		10

Operating activities (direct method)	**Dr.**	**Cr.**	**Change**
Cash collected from customers	$520		
Payments for purchases		$210	
Payments for selling expenses		80	
Payments for G & A expenses		40	
Payments for **Interest**		25	
Payments for **Taxes**		30	
Net cash **provided** by Operating activities	$520	$385	**$135**

Note: Under the direct method, nonoperating Gains and losses are ignored. Noncash items such as depreciation, credit loss expense, amortization expense and Equity in Earnings are also ignored unless already included in Selling expense (credit loss expense in this example), then adjust.